

REPORT OF EXAMINATION  
OF THE

PREFERRED EMPLOYERS  
INSURANCE COMPANY

AS OF  
DECEMBER 31, 2009

Filed June 10, 2011

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Los Angeles, California  
March 18, 2011

Honorable Dave Jones  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Chairman, Secretary, and Commissioner:

Pursuant to your instructions, an examination was made of the

PREFERRED EMPLOYERS INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records and statutory home office at 1455 Frazee Road, Suite 1000, San Diego, California 92108.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2006. This examination covers the period from January 1, 2007 through December 31, 2009. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2009, as deemed necessary under the circumstances.

This examination was a multi-state coordinated examination and conducted concurrently with other insurance entities in the holding company group, and included participation from the following States: Alabama, Arizona, Delaware, Iowa, Minnesota, New Hampshire, North Carolina, North Dakota, and Texas.

In addition to those items specifically commented upon in this report, other phases of the Company's

operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

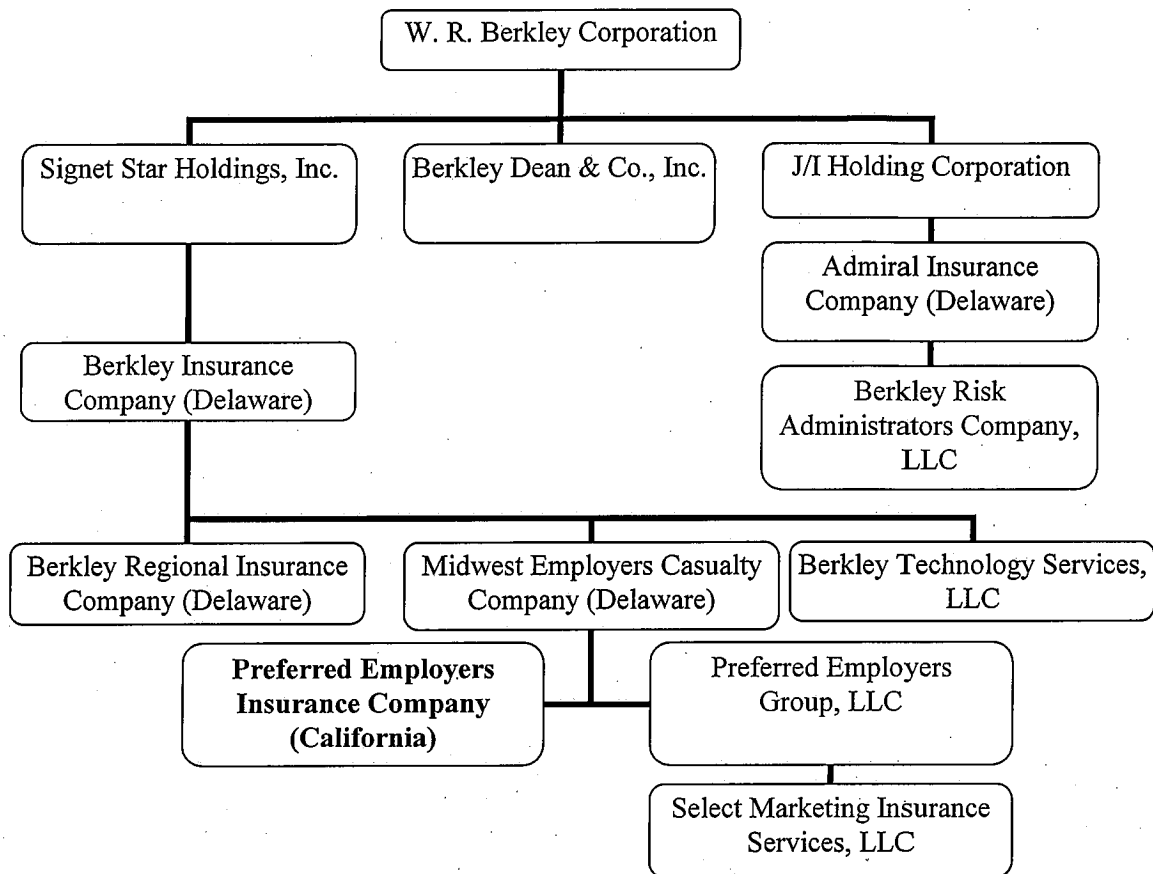
### COMPANY HISTORY

The Company was incorporated in California on December 11, 1997, and commenced transacting workers compensation insurance on June 1, 1998. All outstanding shares of the Company are owned by its parent, Midwest Employers Casualty Company (MECC), a Delaware property and casualty insurance company. The ultimate controlling parent, W.R. Berkley Corporation, is an insurance holding company that is publicly traded on the New York Stock Exchange, whose business strategy focuses on being a commercial lines property and casualty insurance provider.

On October 23, 2009, the Company paid an ordinary dividend of \$4,296,243 in cash and securities to its parent, MECC. Subsequent to the examination date, on October 27, 2010, the Company paid an ordinary dividend of \$4,340,475 in cash and securities to its parent, MECC. The dividend transactions did not meet or exceed the thresholds requiring California Department of Insurance (CDI) approval; however, for both transactions, the Company submitted notice of the dividend transactions to the CDI before the payment of the dividends.

### MANAGEMENT AND CONTROL

The Company is part of an insurance holding company system of which W.R. Berkley Corporation is the ultimate controlling entity. The following abridged organizational chart depicts the Company's relationship within the holding company system: (all ownership is 100%)



Management of the Company is vested in a three-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2009 follows:

#### Directors

##### Name and Residence

Ira S. Lederman  
Greenwich, Connecticut

Linda R. Smith (\*)  
San Diego, California

Robert D. Stone  
Greenwich, Connecticut

##### Principal Business Affiliation

Senior Vice President  
W.R. Berkley Corporation

President and Chief Executive Officer  
Preferred Employers Insurance Company

Senior Vice President  
W. R. Berkley Corporation

### Principal Officers

<u>Name</u>	<u>Position</u>
Linda R. Smith (*)	President and Chief Executive Officer
Timothy J. Wiebe	Vice President, Chief Financial Officer and Treasurer
Tom Boggs	Vice President
Jan A. Beaver	Vice President and Secretary
John C. Bennett	Vice President, Underwriting
Rosemary Favier	Senior Vice President, Claims
Randy Sysol	Vice President, Information Technology
Marc J. Beaulieu	Senior Vice President, Marketing
(*) Resigned as President and Chief Executive Officer effective December 1, 2010, but retained position as a director and chairman of the board. Mr. Steven A. Gallacher named President of the Company, effective December 1, 2010.	

### Management Agreements

Administrative Service Agreement: Effective February 1, 2006, the Company entered into an Administrative Service Agreement with its subsidiary, Select Marketing Insurance Services, LLC (SMI). Under the terms of the agreement, SMI markets and solicits workers' compensation insurance business on behalf of the Company, and is compensated by the Company based on the actual cost of the services it provides. Conversely, the Company provides SMI with human resources, accounting functions, computer resources, and office facilities, and is compensated by SMI for the actual cost of these services. For the 2007, 2008, and 2009 years, the Company paid SMI \$120,053, \$107,164, and \$175,308, respectively, under the terms of this agreement. The California Department of Insurance (CDI) approved this agreement on December 27, 2005.

Management and Administration Agreement: Effective January 1, 2009, the Company entered into a Management and Administration Agreement with an affiliate, Preferred Employers Group, LLC (PEG). Under the terms of the agreement, the Company appointed PEG as its legal representative and lawful attorney for the purpose of transferring the servicing and performance of most of its administrative and operational functions to PEG, such as personnel, management, facilities, accounting, books and record maintenance, premiums collections, underwriting, claims handling, reinsurance assistance, marketing assistance, and information technology systems. The Company

compensates PEG the actual cost of these services. For the 2009 year, the Company paid PEG \$9 million under the terms of this agreement. The CDI approved this agreement on November 20, 2008.

Computer Services Agreement: Effective January 1, 2002, the Company entered into a Computer Services Agreement with its affiliate, Berkley Technology Services, LLC (BTS). Under the terms of the agreement, BTS provides the Company with computer and data processing services, including programming, network management, operations, and consulting services. BTS is compensated by the Company for the actual cost of these services. For the 2007, 2008, and 2009 years, the Company paid BTS \$839,858, \$1,093,258 and \$1,125,431, respectively, under the terms of this agreement. The CDI approved this agreement on February 15, 2002.

Underwriting Services Agreement: The Company was party to an Underwriting Services Agreement, effective date September 6, 2002, with an affiliate, Berkley Risk Administrators Company, LLC (BRAC). The CDI approved this agreement on September 5, 2002, and the Company terminated the agreement on November 2, 2007. There were no transactions reported under the terms of this agreement during the examination period; however, a review noted that the status of this agreement was not accurately disclosed in accordance with California Insurance Code (CIC) Section 1215.4(e) (Form B filing) within its most recent filing, as the agreement was reported as still being in force. Therefore, it is recommended that the Company amend its Form B filing to accurately disclose the current status of this terminated agreement.

Investment Advisory Agreement: Effective April 23, 1998, the Company entered into an Investment Advisory Agreement with an affiliate, Berkley Dean & Co., Inc (BDC). In accordance with the Company's investment guidelines, BDC provides investment advisory and management services. BDC is compensated based on an annual fee equal to .25 of 1% of the first ten million dollars and .20 of 1%, thereafter, of the net asset value of the portfolio at the end of each quarter. The CDI approved this agreement on April 27, 1998. For the 2007, 2008, and 2009 years, the Company paid BDC \$133,043, \$137,262, and \$143,147, respectively, under the terms of this agreement.

Tax Allocation Agreement: The Company is a party to a Tax Allocation Agreement with its affiliates and its ultimate parent, W.R. Berkley Corporation (WRB). Under the terms of this agreement, the companies file a consolidated federal income tax return. The consolidated federal income tax liability is allocated between the companies in the ratio that each company's separate tax return liability bears to the total consolidated federal tax liability. This agreement was approved by the CDI on April 27, 1998. The Company paid the following taxes during the examination period:

<u>Year</u>	<u>Amount</u>
2007	\$ 2,145,955
2008	928,165
2009	<u>1,140,237</u>
Total	<u>\$ 4,214,357</u>

#### TERRITORY AND PLAN OF OPERATION

As of December 31, 2009, the Company was licensed to transact workers' compensation insurance in California only. In 2009, the Company wrote \$52.6 million of direct premiums, consisting exclusively of workers' compensation business. Currently, there are more than 12,000 policyholders, and the Company focuses most of its business on the particular needs of smaller sized businesses that employ fewer than fifty employees.

Business is marketed and produced through a network of independent agents located throughout California. Besides its statutory home office in San Diego, California, the Company has a claims adjusting office located in Walnut Creek, California.

#### REINSURANCE

##### Assumed

The Company does not assume reinsurance.



Ceded

The largest net amount retained by the Company is \$500,000 on any one risk.. The following is a summary of the principal reinsurance agreements in-force as of December 31, 2009:

Type of Contract and Lines of Coverage	Reinsurer(s) Name	Company's Retention	Reinsurer's Maximum Limits
Quota Share			
Quota Share	Berkley Insurance Company (Authorized)	10% of net excess of loss liabilities	90% of net excess of liabilities
Excess of Loss			
Workers' Compensation First Layer	Various/Authorized (14%) and Unauthorized (86%)	\$5 million per occurrence	\$5 million excess of \$5 million per occurrence, limited to \$10 million aggregate during term
Workers' Compensation Second Layer	Various/Authorized (19%) and Unauthorized (81%)	\$10 million per occurrence	\$15 million excess of \$10 million per occurrence, limited to \$30 million aggregate during term
Workers' Compensation Third Layer	Various/Authorized (61.25%) and Unauthorized (38.75%)	\$25 million	\$20 million excess of \$25 million per occurrence, limited to 40 million per term
Other Excess of Loss			
Casualty Contingency 2 <sup>nd</sup> Excess of Loss	Various Authorized	\$5 million each loss occurrence	\$5 million excess of \$5 million per occurrence, limited to \$20 million aggregate during term
Casualty Contingency 3 <sup>rd</sup> Excess of Loss	Various Authorized	\$10 million each loss occurrence	\$10 million excess of \$10 million per occurrence, limited to \$40 million aggregate during term

As of the examination date, and under the terms of its reinsurance agreements, the Company reported total reinsurance recoverables of \$161.4 million or 372% of reported surplus. The vast majority, 99.6%, of these reinsurance recoverables are due from an affiliate, Berkley Insurance Company, under the terms of the 90% quota-share reinsurance agreement.

### FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2009

Underwriting and Investment Exhibit for the Year Ended December 31, 2009

Reconciliation of Surplus as Regards Policyholders from December 31, 2006  
through December 31, 2009

Statement of Financial Condition  
as of December 31, 2009

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 61,784,500	\$	\$ 61,784,500	(1)
Cash and short-term investments	1,065,474		1,065,474	
Other invested assets	1,000	1,000		
Investment income due and accrued	802,366		802,366	
Premiums and agents' balances in course of collection	1,102,703	59,790	1,042,913	
Reinsurance:				
Amount recoverable on reinsurers	7,883,002		7,883,002	
Federal income tax recoverable	101,884		101,884	
Net deferred tax asset	1,557,482	1,178,680	378,802	
Guaranty funds receivable or on deposit	20,217,642	69,093	20,148,549	(2)
Electronic data processing equipment	199,730	199,730		
Furniture and equipment	238,201	238,201		
Aggregate write-ins for other than invested assets	<u>1,791,894</u>	<u>8,480</u>	<u>1,783,414</u>	
Total assets	<u>\$ 96,745,878</u>	<u>\$ 1,754,974</u>	<u>\$ 94,990,904</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 12,224,592	(3)
Loss adjustment expenses			3,956,893	(3)
Commissions payable, contingent commissions and other similar			63,708	
Other expenses			684,235	
Taxes, licenses, and fees			16,871,223	(2)
Unearned premiums			797,821	
Ceded reinsurance premiums payable			10,155,788	
Payable to parent, subsidiaries and affiliates			2,262,233	
Aggregate write-ins for liabilities			<u>4,617,696</u>	
Total liabilities			51,634,189	
Common capital stock		\$ 3,500,000		
Gross paid-in and contributed surplus		7,500,000		
Unassigned funds (surplus)		<u>32,356,715</u>		
Surplus as regards policyholders			<u>43,356,715</u>	
Total liabilities, surplus and other funds			<u>\$ 94,990,904</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2009

Statement of Income

Underwriting Income

Premiums earned		\$ 5,296,892
Deductions:		
Losses incurred	\$ 958,987	
Loss expense incurred	(149,261)	
Other underwriting expenses incurred	<u>1,806,432</u>	
Total underwriting deductions		<u>2,616,158</u>
Net underwriting gain		2,680,734

Investment Income

Net investment income earned	\$ 2,585,252	
Net realized capital gains	<u>239,983</u>	
Net investment gain		2,825,235

Other Income

Net loss from agents' balances charged off	<u>\$ (19,488)</u>	
Total other income		<u>(19,488)</u>
Net income before federal income taxes		5,486,481
Federal income taxes incurred		<u>1,146,008</u>
Net income		<u>\$ 4,340,473</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2008		\$ 42,962,426
Net income	\$ 4,340,473	
Change in net unrealized capital gains	20,548	
Change in net deferred income tax	(364,692)	
Change in nonadmitted assets	694,203	
Dividends to stockholders	<u>(4,296,243)</u>	
Change in surplus as regards policyholders		<u>394,289</u>
Surplus as regards policyholders, December 31, 2009		<u>\$ 43,356,715</u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 2006 through December 31, 2009

Surplus as regards policyholders, December 31, 2006,  
per Examination

\$ 23,629,656

	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>
Net income	\$ 14,373,476	\$
Change in net unrealized capital gains	20,548	
Change in net deferred income tax		490,435
Change in nonadmitted assets	1,046,123	
Dividends to stockholders		4,296,243
Aggregate write-ins for gains in surplus	<u>9,073,590</u>	
Totals	<u>\$ 24,513,737</u>	<u>\$ 4,786,678</u>

Net increase in surplus as regards policyholders for the examination

19,727,059

Surplus as regards policyholders, December 31, 2009,  
per Examination

\$ 43,356,715

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Bonds

The Delaware Insurance Department was the lead state for this multi-state coordinated examination, and they performed a review of the WR Berkley Corporation Group's (the Group) custodial agreements, and noted that a number of the custodial agreements did not contain all of the required provisions in accordance with the National Association of Insurance Commissioners Financial Condition Examiners Handbook. The examination finding pertained to various entities within the Group, including the Company. During the course of the examination, and based on this finding, the Group drafted new custodial agreements to remedy the deficiencies. It is recommended that Company submit its newly executed custodial agreement to the California Department of Insurance, in accordance with California Insurance Code Section 1104.9 (d).

### (2) Guaranty Funds Receivable or on Deposit

#### (2) Taxes, Licenses and Fees

In 2000, the California Insurance Guaranty Association (CIGA) began assessing the Company for its share of policyholder obligations relating to several insolvencies of companies writing workers' compensation business in California. As of December 31, 2009, the Company estimated a remaining liability of \$17.2 million associated with these assessments and reported it under the above captioned Taxes, Licenses and Fees liability account.

The Company recoups the guaranty fund assessments through a 2% surcharge on its policyholders' premiums. The Company reported a \$20.2 million asset for the 2% surcharge in the above captioned receivable account.

The above captioned asset and liability accounts were established in accordance with Statements of Statutory Accounting Principles No. 35.

### (3) Losses and Loss Adjustment Expenses

A Casualty Actuary from the California Department of Insurance analyzed the Company's loss and loss adjustment expense reserves. Based on the analysis, the Company's loss and loss adjustment expense reserves as of December 31, 2009 were determined to be reasonably stated and have been accepted for purposes of this examination.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

### Current Report of Examination

Management Agreements – Underwriting Services Agreement (Page 4): It is recommended that the Company amend its most current Form B - Annual Registration Statement filing in order to update the current status of Underwriting Service Agreement in accordance with the Insurance Holding Company Regulatory Act, California Insurance Code (CIC) Section 1215.4(e).

Bonds (Page 12): It is recommended that the Company submit its newly executed custodial agreement to the CDI in accordance with CIC Section 1104.9 (d).

### Previous Report of Examination

None.

### ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

\_\_\_\_\_/s/\_\_\_\_\_  
Vivien Fan, CFE  
Examiner-In-Charge  
Department of Insurance  
State of California